

Progressive Economics Group (PEG)

Policy Brief

Using the Budget to Manage Employment & Output

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January 2018

Policy Issue

After the economy showed strong recovery in 2009 and 2010, eight years of austerity policies by Conservative governments brought recession, stagnation and faltering growth. Various excuses offered by Tory politicians, from world market instability to Brexit anxieties, fail to conceal the basic cause of this historically dismal economic performance. In the foreseeable future it will be the responsibility of a Labour government to manage the economy.

What policy framework will a Labour government use to maintain a high and stable level of employment and output?

Policy Analysis

Much of the public and many politicians, even in the Labour Party, believe that commitment to match public revenue with public expenditure represents a sensible, sound and achievable fiscal policy. This generally accepted Fiscal Balance Rule (FBR) gives rise to several sources of disagreement: 1) when and how rapidly to achieve it, 2) what specific measure of the budget requires balancing, and 3) what policies the government should apply to bring the balance about.

This deficit fetishism of Tory governments makes all public policy captive to hitting the zero overall fiscal balance, or overshoot into surplus. Until recently the repeated failures to achieve fiscal targets did not weaken the grip of this extreme version of the FBR over the public mind and the media.

Even the superficially sensible Institute for Fiscal Studies focuses on the minutiae of the fiscal deficit rather than critiquing the ideology of the budget balancing. Even worse, Tory chancellors suffer criticism for not eliminating borrowing, though doing so would provoke recession. The responsible approach to this fiscal mismanagement is not to re-calculate the likely success of reaching a balanced public budget, but to label the policy it for what it is, pernicious nonsense.

Tory success in inculcating belief in the virtue of balanced budgets has proved so ideologically successful that it compels all politicians to commit to some balancing rule. The Labour shadow chancellor has found a flexible and non-ideological variation. The McDonnell budget guideline commits the Treasury to balancing current (i.e. non-capital investment) expenditure and revenue as a *possible* outcome of countercyclical output stabilization, not as a goal.

However, a basic problem with the FBR in all its versions is the inherent improbability of achieving it. The improbability emerges clearly when we inspect the

conditions for its successful implementation. Private and public demand together determine the level of national income, which for the last eight years has stagnated below its potential. To keep the discussion simple, I leave out foreign trade, treat private investment as constant, all public revenue is strictly proportional to national income (for example, at 35%), and assume current household disposable income determines current household consumption.

Assume that the budget balance is negative and we have a Tory chancellor, committed to reduce the deficit quickly. He or she can increase taxes or reduce expenditure. Conservative chancellors have favoured expenditure cuts. Expenditure cuts reduce aggregate demand, causing a fall in national income and disposable income. These declines result in a fall in corporate and household tax revenue. As a result, public borrowing declines by less than the cuts themselves.

Even in this simple case in order to maintain orderly fiscal management and meet his specified targets the Chancellor must have an accurate estimate of an interactive system that includes the second round effect of a cut in public expenditure on tax revenue. To assess this interaction the Chancellor and advisers need to know at the minimum the values of two key behavioural relationships – the marginal tax-to-GDP ratio and the margin consumption-to-income ratio for households (“marginal propensity to consume”).

The repeated failures of Tory governments to meet their own fiscal targets demonstrate that the concrete, real world feedbacks prove extremely difficult to estimate. Complications include the openness of the UK economy to foreign trade, variations in time of adjustment for revenue collection, and private investment decisions. Estimates of macroeconomic interactions can be made, but they come with a substantial marginal of error (“random variation”). When to the feedback interactions we add changes in tax rates and regulations, forecasts become uncertain to the point of unpredictable.

Eventually expenditure reductions will balance the public budget, albeit at the cost of recession. Far more complicated than chasing a zero deficit is to balance expenditure and revenue in an economy with changing levels of output, “over the business cycle”. Calculating the interactions and feedbacks among economic variables over time when basic parameters such as tax rates change is the most obvious problem with a multi-year fiscal commitment.

Even prior to that, intractability begins with defining and measuring “the economic cycle”, which in practice can only be done *ex post*. However, an over-the-cycle fiscal target requires an *ex ante* estimate of the future course of the economy. Neither the beginning nor the end of a cycle is predictable even in principle.

If the promise to “balance the books” is retrospective, then achieving it depends on definition and measurement. One cycle ends when the next begins, and that tautology provides not guide to policy. Definition and measurement of cycles should not be tasks assigned either to the Treasury or the Office of Budget Responsibility. The former has a conflict of interest (never wants to be wrong) and the latter’s competence for this purpose is extremely dubious.

More fundamental than definition and measurement is what a Chancellor thinks causes “the economic cycle”. Cameron and May governments view the cycle as a natural phenomenon that occurs independently of the actions of policy makers. It cannot be avoided. Like the weather the government can only prepare for its impact (“repair the roof while the sun shines” Osborne was fond of saying).

Managing the economic cycle to minimize instability is simultaneously management of revenue and expenditure. Expenditure policies are a major determinant of tax revenue flows. For an enlightened Chancellor the expenditure-revenue interaction is a blessing because of the automatic stabilizing effect of revenue flows. The balance between revenue and expenditure – “making ends meet” – becomes an outcome derivative from the primary task of a rational, pragmatic Chancellor, minimizing market instability at the aggregate level.

This rational approach to fiscal management – in contrast to the illusion of deficit management – can under unusual circumstances encounter a public debt constraint. Since the end of WWII this constraint has not been operative for UK policy makers. Understanding the nature of this constraint and why it is unlikely requires overcoming an ideological phobia as powerful as obsession with balancing budgets See Policy Brief “[Public Debt Management](#)” August 2017).

Policy Framework

Rational economic policy involves using capital expenditure to stimulate medium and long-term growth and current expenditure to keep the economy at a stable and high level of output and employment. The policy guidelines for this active fiscal policy are below.

1. **Public investment (the capital budget)** is the instrument to stimulate growth. Its relative inflexibility in the short run makes it an inefficient instrument for short-term management of output and employment.
2. **Adjusting current expenditure** provides the tool to counteract the waxing and waning of private investment and exports that would otherwise cause overheating and under-utilization.
3. **The public budget may show a surplus or a deficit** during this regime of active fiscal policy depending on the budget measure selected, the time period and private sector behaviour. Vigorous private sector demand favours a surplus, while weak private spending implies a deficit. By dampening cyclical extremes, demand management indirectly moderates variations in revenue flow.
4. **The balance between expenditure and taxation** is the outcome of an active fiscal policy, not a policy goal.

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